

TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

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SUBJECT: Annual and Semi-annual report on the  
California Investment Policy and Education Code Section § 22362

ITEM NUMBER: 12

ATTACHMENTS: 1

ACTION: \_\_\_\_\_

DATE OF MEETING: October 2, 2002

INFORMATION: X

PRESENTER: Christopher Ailman

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Executive Summary:

In accordance with the policy on California Investments, the staff presents the annual report on net cash flow investments in real estate debt as required by Education Code section §22362. This report also serves as the semi-annual report on the Fund's investments within California and within the underserved portions of California. The information in the report covers the prior fiscal year and the holdings as of June 30, 2002.

**Background**

Annual Report: Education Code Section §22362, sets forth the legislative priority to invest 25% of the CalSTRS net cash flow into debt instruments secured by California residential real estate. This priority is subservient to the Board's mandates, as set forth in the California Constitution and the Education code, to make prudent investments and achieve a maximum rate of return at a prudent level of risk. Annually, CalSTRS is required to prepare a report on the free cash flow and level of California real estate investments. If the priority or goal is not met, CalSTRS is required to report the rationale for not meeting the goal to the Legislature and others.

Semi-annual report: This report was originally created in June of 2001 to provide the Committee with a perspective on the Fund's holding within the State. The report has become formalized with the adoption of the California Investment Policy. As with many reports, this report can be revised and customized to meet the Committees desires.

In accordance with the Policy, the emerging portions of the State are described as: "California emerging markets investments shall focus on investment opportunities in traditionally underserved markets primarily located in California. For example, underserved markets would include urban and rural communities undergoing, or in need of, revitalization where there are assets (e.g. an available labor pool, underutilized infrastructure) conducive to business development."

The bulk of CalSTRS assets in U.S Equity, Non-U.S., and U.S corporate fixed income have direct, and in-direct, exposure into these locations, unfortunately, it is extremely difficult to slice out these exposures or even develop a crude estimation of their exposure. For example, our holdings in Wal-Mart, Safeway, PepsiCo, Kellogg, 3M, Exxon, Chevron, and even No-U.S. companies such as Royal Dutch Petroleum, Nokia, or Nestlé have significant business exposure to these communities. In fact, these corporations often comprise an integral part of the fabric of these communities, however, it is difficult to measure the actual exposure of these large firms.

The report has been enhanced to include the Fund's public equity holdings in companies that are incorporated or headquartered in the State. We have also listed the exposure to the largest publically traded employers within the State. However, the investments in underserved portions of California only cover the direct/private investments in the underserved areas. As a result, this report clearly understates the total CalSTRS investment exposure to the underserved markets of California.

### **Discussion**

Annual Report: While CalSTRS has been able to meet this objective through the normal course of business, this legislative objective is outdated compared to our peers. The similar statutes for other California pension plans were deleted many years ago. The Board's constitutional requirement to diversify the fund, and its investments, to achieve a maximum rate of return (at a prudent level of risk) supercedes this section of the Education Code. At some future date, staff may suggest legislative action to update this section of the code.

Semi-annual report: All the investments listed in the report were made as part of the normal course of business. In accordance with the California Investment policy all of these were made in accordance with the CalSTRS investment objectives and with the singular primary purpose of receiving a maximum rate of return commensurate with the given level of risk. It is recognized, that as an ancillary benefit, our investments help spur business activity, and as a result, they provide economic growth and revitalization to the State of California and its underserved portions. These investments receive the same level of due diligence as any investment made by CalSTRS.


### **Conclusion**

Annual Report: As can be seen on the attached report, and labeled **Attachment 1**, the net cash flow for fiscal year 2001-2002 was \$2,622 million. The priority of 25 percent of that amount equals \$655.6 million dollars. Total California residential debt purchased was \$ 1,622 million. Therefore the Legislative objective was met, and in fact, exceeded the objective by almost \$1 billion dollars.

Semi-annual report: As noted on the attached table, in excess of \$10 billion or 10 percent of the CalSTRS portfolio is invested in the State of California. The exposure declined from 11.8 percent at December 31, 2001, due to the drop in the stock market. Please keep in mind, the overall dollar amount is understated, because it only includes a low estimation of the overall exposure with the largest portion of the CalSTRS assets invested through the public equity and the broad fixed income portfolio.

Additionally, CalSTRS has \$1.86 billion, which represents 1.92 percent of the total CalSTRS portfolio invested in the underserved areas/emerging markets of California. The amount increased over the prior period due to an increase in the amount of mortgaged-backed securities that are within CRA zones. While the investment staff is very pleased to report that we are very close to the Policy's goal of 2 percent invested in these areas, staff must note that the amount invested in mortgages can, and will, fluctuate greatly. As a result, staff does not recommend increasing the goal just yet. The Committee might want to wait until the portfolio consistently meets the goal before considering an increase to the overall policy goal. With the allocations and commitments made by the Investment Committee in 2002, the sustained exposure will grow rapidly in fiscal year 2002 – 2003.

Prepared on September 11, 2002 by:



Christopher Ailman  
Chief Investment Officer

**CalSTRS Investment Portfolio  
California Content  
As of June 30, 2002**

The CalSTRS U.S. public equity portfolio, the largest asset class within CalSTRS, has a very large exposure to California through many national corporations that are both major employers and major business within the State. Unfortunately, many companies do not break out their business activity by State, so the exposure for this asset class is a conservative estimation based on companies that are either incorporated or headquartered, plus the 20 largest public employers within the State.

(In Millions)

<b>Asset Class</b>	<b>Market Value</b>
Publicly traded equity (estimated)	\$4,704
Corporate fixed income (estimated)	\$508
Fixed Income – MBS	\$1,094
Individual Home Loans	\$528
Real Estate	\$1,390
Private Equity	\$489
Credit Enhancement	\$1,312
<b>Estimated California Exposure</b>	<b>\$10,025</b>
<b>% Of CalSTRS portfolio</b>	<b>10.4%</b>
<b>% Of CalSTRS portfolio invested in the bottom five assets classes</b>	<b>26.2%</b>

Investments in Underserved / Emerging markets of California, (in Millions)

<b>Asset Class</b>	<b>Market Value</b>
Fixed Income MBS	\$588.8
Individual Home Loans	\$68.6
Real Estate	\$294.7
Private Equity	\$21.4
Credit Enhancement	\$887.0
<b>Estimated Exposure to Underserved California</b>	<b>\$1,860.6</b>
<b>% Of CalSTRS portfolio</b>	<b>1.92%</b>
<b>% Of CalSTRS portfolio invested in the above assets classes</b>	<b>10.1%</b>

### **CalSTRS investment exposure to the largest publicly traded employers in California.**

In the U.S. public equity portfolio and corporate fixed income has over \$2.9 billion invested with some of California's largest public employers. This is not an exhaustive list. The total investment exposure to California companies and employers far exceeds \$10 billion. However, due to the difficulty in measuring the California content of most of the Fund's holdings national and multi- multinational corporations, an exact figure cannot be generated. The following table lists the exposure to companies either headquartered or incorporated with California. These lists clearly underestimate the overall exposure to the California economy within the U.S., Non-U.S. and bond portfolios, which comprise the bulk of CalSTRS assets.

Data based on public companies with 10,000 or more and sales revenues of \$1 billion or more.

<b>COMPANY</b>	<b>CalSTRS Investment</b>
Intel Corporation	\$679,543,483.70
Cisco Systems Inc.	\$425,993,507.27
Oracle Corporation	\$251,329,515.76
Wells Fargo & Company	\$356,032,132.75
Chevron Corporation	\$337,985,762.31
Sun Microsystems Inc.	\$128,344,977.30
Walt Disney Company	\$136,677,117.92
Hewlett Packard Company	\$117,453,204.18
Safeway Inc.	\$118,365,060.47
Tenet Healthcare Corporation	\$133,194,268.04
GAP Inc.	\$33,676,781.72
Agilent Technologies	\$39,084,330.49
Computer Sciences Corporation	\$84,706,583.02
Mattel Inc.	\$29,750,203.60
Northrop Grumman Corporation	\$57,029,133.03
Hilton Hotels Corporation	\$13,371,048.60
Fluor Corporation (New)	\$7,894,466.80
Jack in the Box	\$4,403,012.58
ABM Industries Inc.	\$1,989,721.80
Dole Food Inc.	\$2,918,030.80
<b>TOTAL</b>	<b>\$2,959,742,342.14</b>

(Based on data from the public reference USA Database)

## **Annual Report on the California Education Code Section §22362 For Fiscal-Year 2001-2002**

**Establishing a priority for California residential realty from the CalSTRS net cash flow.**

### Net Cash Flow

Employee and Employer Contributions	\$4,513,506,609
Investment Income	\$2,688,932,371
Less Benefits paid & withdrawals	<u>(\$4,579,917,588)</u>
Net Cash Flow	<u>\$2,622,521,392</u>
<b>25% priority of Net Cash Flow</b>	<b><u>\$655,630,348</u></b>

### California residential real estate debt investments purchased during the past fiscal year:

Publicly traded Mortgage Backed Securities	\$1,094,170,050
HLP – residential home loans	\$528,042,435
<b>TOTAL Residential Real Estate Debt</b>	<b><u>\$1,662,212,485</u></b>

**Total Investment less 25% priority** **Exceeded by \$ 966,582,137**

**COMPLIANCE WITH CODE SECTION** ☒